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Organization =
X =
State1 =
Corporations =
Y =
Company =
Show =

Dear :

This is in response to Organization's letter dated April 4, 2016, in which Organization requested certain rulings with respect to §§ 4941 and 4943 of the Internal Revenue Code.

FACTS

Organization is an exempt organization described in § 501(c)(3) and classified as a private foundation under § 509(a). Organization is a foundation under the laws of State1 dedicated to supporting children, education, and health services.

X, hosted Show for many years on television, during which he became an American icon. During X's career he was able to negotiate an agreement with the television network for the copyrights, name and likeness rights, and publicity rights to Show and other special shows. During X's life these copyrights, name and likeness rights, and publicity rights were held by two corporations (collectively Corporations), S corporations held entirely by a taxable trust in X's name.

X and Y, are family members that are not described in § 4946(d). X and Y had an employment relationship that spanned several decades. Over the decades, Y was

employed on Show and started as a summer intern and worked his way up to producer. During the years that Y was employed on Show, he traveled closely with X and became his confidant, trusted advisor, and creative partner.

After X's retirement, Y continued to work with X to manage the licensing of the episodes of Show and evaluate other projects. Y worked with X to help distribute episodes of Show. Y gained a deep understanding over time of the content of the episodes of Show and other intellectual property (licenses and copyrights) associated therewith, and therefore acquired an encyclopedic knowledge of all of the episodes of Show.

Based upon their long-term relationship, X decided to grant the exclusive right to market Show to Company, an organization wholly owned by Y, by entering into license agreements between Corporations and Company. The license agreements between Corporations and Company gave Company the sole and exclusive rights to license, rent, lease, exhibit, distribute, reissue, and deal in the episodes of Show (and the movies created therefrom) as well as all ancillary rights, including merchandising and music rights of Show. The license agreements between the companies provided a profit share in the revenue from the use of these rights with a majority to Corporations and the remainder to Company. The license is just over half way beyond the term of the license. The agreement could have been terminated by X at any time prior to his death, and the agreement would be terminated if Y lost control of 100 percent of Company or no longer otherwise controlled Company.

Upon X's death and through the administration of his estate, the rights and privileges associated with the episodes of Show owned by Corporations were distributed to Organization by the terms of the trust that owned Corporations. Additionally, the license agreements between Corporations and Company were transferred to Organization.

After Organization received the rights and privileges associated with the episodes of Show, a separate agreement was entered into between Organization and Company as to publicity rights. This agreement provides Company the exclusive right to license any publicity rights for X's name and likeness.

Y has been an advisor to Organization. Organization has represented that at no point has this advisory role risen to the level of managing Organization as described in 4946(b)(1).¹ Y does not participate in governance or financial decisions regarding Organization, including, but not limited to investment or operational expenses. Y's long and close relationship with X enables Y to advise Organization about the types of charitable work that X desired with regard to Organization. Additionally, Y's presence as an advisor enables Y to support Organization's charitable work by providing access

¹ While Y has never acted as a director for Organization, Y had been appointed as a director of Organization's predecessor foundation by X. Y resigned as the director of the predecessor foundation during the administration of X's estate. Subsequently, the predecessor foundation merged into Organization.

to nonpublic stories about X to share with donees. For these reasons, Organization represents that Y provides unique attributes that would be beneficial to furthering Organization's exempt purpose. Organization also states that appointing Y as an officer and a director is consistent with X's wishes. Therefore, Organization wants Y to serve as a director and officer of Organization.

Further, Organization has reviewed its assets and thinks it is in its best interest to transfer the license agreements, copyrights, publicity rights agreement and name/likeness rights from the episodes of Show into a limited partnership, LP. The transfer of the intellectual property rights into LP will provide greater liability protection to Organization and its other assets in the event of any litigation related to the intellectual property rights. LP will receive passive income in the form of royalties and license fees and will not engage in any other activities or earn income from any other source. Organization plans on creating a wholly owned corporation that will then be the general partner of LP and hold a one percent share of the interest of LP. The remaining ninety-nine percent of the ownership of LP would belong to Organization as a limited partner. LP would engage in no activities other than holding and managing all of the intellectual property rights associated with the episodes of Show and would retain the license agreements and publicity rights agreement for those rights with Company.

Organization commissioned a report produced by a third party entertainment consulting firm that shows that Company holds a unique advantage over others for licensing rights to these episodes. The report's conclusion relies on the long relationship between X and Y, the long and continuous work on the episodes of Show that make up the basis of the intellectual property, and the trust X put in Y over multiple decades. The report also provides information on a proprietary system used by Company to search and access the numbers of interviews, skits, or general themes present in the episodes. Finally, the report provides that Y, due to his experience with X, has an encyclopedic knowledge of the episodes providing a real time response to the types of clips and videos that might be available to a potential user. For these reasons, the consulting firm concludes that Company, as run by Y, provides a unique service for the sell, licensing, and distribution of Organization's intellectual property rights in X's episodes that could not be matched by other firms or systems without substantial harm to Organization's income from licensing the rights to the episodes. The report also concludes that Company can perform the services at a much lower cost of operations because of Y's deep knowledge and ability to catalogue, find, and describe the necessary clips on his own, providing much lower overhead than other firms in that industry. The lower overhead leads to a return that is at least as favorable as can be found from other firms offering similar services.

Company's sole business is to license, rent, lease, exhibit, distribute, reissue, and deal in the Show episodes (and the movies created therefrom) as well as all ancillary rights, including merchandising and music rights for these episodes of Show. Company has no other business and is not in a position to perform similar services for other

entertainment material. Y's knowledge of X's work makes Y uniquely capable of handling these rights for those episodes, and he could not perform the same services for other materials as he lacks the requisite knowledge and experience.

RULINGS REQUESTED

The following rulings have been requested:

1. Following the transfer of the license agreements, copyrights, publicity rights agreement and name/likeness rights to the LP, Y, sole owner of Company, will be able to serve as a director and officer of Organization without violating the provisions against direct or indirect self-dealing transactions with Organization within the meaning of IRC § 4941 and Treas. Reg. § 53.4941-1(b)(1);
2. Formation of LP and the proposed transfer of the copyrights, license agreements, publicity rights agreements and name/likeness rights to the LP will not constitute "excess business holdings" within the meaning of § 4943.

LAW & ANALYSIS

Section 512(b)(2) of the Code excludes all royalties (including overriding royalties) whether measured by production or by gross or taxable income from the property, and all deductions directly connected with such income from the calculation of unrelated business income tax.

Section 4941(a) of the Code, in part, imposes a tax on each act of self-dealing between a private foundation and a disqualified person. The tax is imposed on the disqualified person and, in certain situations; a tax is also imposed on the foundation manager(s) participating in the act or acts.

Section 4941(d)(1) of the Code provides in part, that the term self-dealing includes the direct or indirect sale, exchange, or leasing of property between a private foundation and a disqualified person; furnishing of goods, services, or facilities between a private foundation and a disqualified person; payment of compensation (or payment or reimbursement of expenses) by a private foundation to a disqualified person; and transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a private foundation.

Section 4943(a)(1) of the Code imposes a tax on the excess business holdings of any private foundation in a business enterprise during any taxable year which ends during the taxable period a tax equal to 10 percent of the value of such holdings.

Section 4943(c)(1) of the Code provides that the term “excess business holdings” means, with respect to the holdings of any private foundation in any business enterprise, the amount of stock or other interest in the enterprise which the foundation would have to dispose of to a person other than a disqualified person in order for the remaining holdings of the foundation in such enterprise to be permitted holdings.

Section 4943(c)(2)(A) of the Code defines permitted holdings as 20 percent of the voting stock, reduced by the percentage of the voting stock owned by all disqualified persons. In any case in which all disqualified persons together do not own more than 20 percent of the voting stock of an incorporated business enterprise, nonvoting stock held by the private foundation shall also be treated as permitted holdings.

Section 4943(c)(2)(B) of the Code provides that, if the private foundation and all disqualified persons together do not own more than 35 percent of the voting stock of an incorporated business enterprise, and it is established to the satisfaction of the Secretary that effective control of the corporation is in one or more persons who are not disqualified persons with respect to the foundation, then subparagraph (A) shall be applied by substituting 35 percent for 20 percent.

Section 4943(d)(1) of the Code provides that in computing the holdings of a private foundation, or a disqualified person (as defined in section 4946) with respect thereto, in any business enterprise, any stock or other interest owned, directly or indirectly, by or for a corporation, partnership, estate, or trust shall be considered as being owned proportionately by or for its shareholders, partners, or beneficiaries.

Section 4943(d)(3)(B) of the Code provides that, for purposes of § 4943, the term “business enterprise” does not include a trade or business at least 95 percent of the gross income of which is derived from passive sources. For purposes of subparagraph (B), gross income from passive sources includes, in part, the items excluded by § 512(b)(2).

Section 4946(a)(1) of the Code provides that the term “disqualified person” means with respect to a private foundation, a person who is ... (B) a foundation manager (within the meaning of subsection (b)(1))... (E) a corporation of which persons described above (including foundation manager) own more than 35 percent of the combined voting power.

Section 4946(b)(1) of the Code provides that the term foundation manager means with respect to a private foundation (1) an officer, director, or trustee of a foundation (or an individual having powers or responsibilities similar to those officers, directors, or trustees of the foundation).

Section 53.4941(d)-1(a) of the Foundation and Similar Excise Tax Regulations provides in part that the term “self-dealing” means any direct or indirect transaction described in section 53.4941(d)-2 of the Regulations.

Section 53.4941(d)-1(b)(1) of the Regulations provides in part that the term “indirect self-dealing” shall not include transactions described in section 53.4941(d)-2 between a disqualified person and an organization controlled by a private foundation if-

(i) The transaction results from a business relationship which was established before such transaction constituted an act of self-dealing (without regard to this paragraph),

(ii) The transaction was at least as favorable to the organization controlled by the foundation as an arm's length transaction with an unrelated person, and

(iii) Either-

(a) The organization controlled by the foundation could have engaged in the transaction with someone other than a disqualified person only at a severe economic hardship to such organization, or

(b) Because of the unique nature of the product or services provided by the organization controlled by the foundation, the disqualified person could not have engaged in the transaction with anyone else, or could have done so only by incurring severe economic hardship.

Section 53.4943-10(a)(1) of the Regulations provides generally that the term “business enterprise” includes the active conduct of a trade or business, including any activity which is regularly carried on for the production of income from the sale of goods or the performance of services and which constitutes an unrelated trade or business under § 513.

Section 53.4943-10(c) of the Regulations provides that the term “business enterprise” does not include a trade or business at least 95 percent of the gross income of which is derived from passive sources. For these purposes, gross income from passive sources includes the items excluded by sections 512(b)(1) (relating to dividends, interest, and annuities) and 512(b)(3) (relating to rent) and any income classified as passive for these purposes does not lose its character merely because section 514 (relating to unrelated debt-financed income) applies to such income. Stock in a passive holding company is not to be considered a holding in a business enterprise even if the company is controlled by the foundation. Instead, the foundation is treated as owning its proportionate share of any interests in a business enterprise held by such company under section 4943(d)(1).

RULING 1:

Barring any exceptions, appointing Y as an officer or director of Organization would result in a situation whereby payments under the license agreements would be acts of self-dealing that are prohibited by Chapter 42 of the Internal Revenue Code. Section 4941 imposes a tax on an act of self-dealing between a private foundation and a disqualified person. Section 4946 defines a disqualified person as any foundation manager, which the code defines as any officer, director, or trustee of the foundation, and any company that is at least thirty-five percent owned by a foundation manager. If Y were appointed as an officer or director of Organization, then Y would become a disqualified person as a foundation manager and his wholly owned corporation, Company, would also become a disqualified person.

Section 4941(d)(1)(D) provides that self-dealing includes, in part, the compensation by a private foundation for the services of a disqualified person. Congress initially created the prohibition on self-dealing so as to prevent any need for costly and ambiguous fair-market evaluations between the private foundations and insiders that Congress saw as creating opportunities for avoiding taxes. General Explanation of the Tax Reform Act of 1969, p. 31 (December 3, 1970). Currently, Organization is a private foundation that owns the intellectual property rights to the various episodes featuring X, and it grants to Company the exclusive right to license, lease, and otherwise exploit the copyrights, name and likeness rights, and publicity rights in exchange for a majority interest in the profits therefrom through the license agreements and publicity rights agreement. If Y and Company become disqualified persons through Y's appointment as a director of Organization, transactions under the license agreements and the publicity rights agreement would constitute acts of self-dealing between a private foundation and its disqualified persons, unless one of the self-dealing exceptions apply, such as the exception described in § 53.4941(d)-1(b)(1).

Based on the information provided, after the transfer to LP, the license agreements and the publicity rights agreement between LP and Company will satisfy the exception to self-dealing found in § 53.4941(d)-1(b)(1). Section 53.4941(d)-1(b)(1) requires three findings for a transaction to be excepted from indirect self-dealing: (1) the transaction must stem from a business relationship that was established before the transaction constituted an act of self-dealing; (2) the transaction must be at least as favorable to the organization controlled by a private foundation as an arm's length transaction; and (3) either the organization controlled by the private foundation would suffer an extreme economic hardship if it could not do business with the disqualified person, or the products or services provided by the organization controlled by the private foundation are so unique that it would cause extreme economic hardship for the disqualified person.

First, the transactions under the agreements must be indirect acts of self-dealing between a subsidiary organization of a private foundation and a disqualified person. Organization's proposed transaction will transfer its copyrights, license agreements,

publicity rights agreements and name/likeness rights to LP, creating an indirect relationship between a subsidiary organization of the Organization and disqualified person to which the exception may apply.

Second, the three requirements of the exception in § 53.4941(d)-1(b)(1) are met. Under these facts, Organization's business relationship with Y and Company related to the licensing of the rights to the Show episodes began more than five years prior to Organization's ownership of the rights to the episodes. The original license agreement did not involve any private foundations thus Chapter 42 of the Internal Revenue Code did not apply; the business relationship was established long before the possible applicability of any self-dealing rules. Further, the publicity rights agreement stems directly from the license agreement and the business relationship established therein. Organization has also provided an independent study showing that the gains from the agreements are at least as favorable as could be achieved through an arm's length transaction and that the services provided by Company and Y are highly unique, and could not be obtained elsewhere without a significant loss in economic value for Organization and could not be provided by Company to others. The fact that Organization is transferring these rights to LP, such that the transactions at issue will be between an organization controlled by Organization and the disqualified persons, does not alter the finding of the requisite prior business relationship and the showing of economic harms within the meaning of § 53.4941(d)-1(b)(1)(i)-(iii).²

Accordingly, based on the representations, the license agreements and publicity rights agreement between Company and LP will not result in indirect acts of self-dealing for purposes of section 4941 due to the exception in § 53.4941-1(b)(1), if Organization appoints Y as a director and officer.

RULING 2:

Section 4943 taxes any excess business holding of a private foundation for any interest in a business enterprise that exceeds twenty percent when combined with the holdings of all disqualified persons. Organization will own over thirty-five percent of both the corporation and LP and would have excess business holdings if either the corporation or LP were a business enterprise.

Section 4943(d)(3)(B) excludes from the definition of a business enterprise any trade or business at least 95 percent of its gross income is derived from passive sources. Section 4943(d)(3)(B) and the regulations thereunder provide that passive sources include those sources of income that are excluded from unrelated business income

² In this regard we note that an indirect relationship between subsidiary organizations and disqualified persons would have existed without the formation of LP if X's estate had transferred the Corporations owning the rights and privileges to the Show to Organization, rather than the rights and privileges separately.

under § 512(b)(1), (2), (3), and (5). Section 512(b)(2) excludes all royalties from unrelated business income.

Organization's subsidiary corporation owns an interest in LP. Since Organization's proportionate share of the subsidiary corporation is 100 percent, under section 4943(d)(3) and § 53.4943-10(c)(1), Organization is treated as owning the full one percent of the LP owned by the subsidiary corporation. Organization is thus considered to own 100 percent interest in LP.

The subsidiary corporation exclusively has passive income under § 53.4943-10(c) because all of its income is derived from ownership of LP; thus, under § 53.4943-10(c)(1), Organization's ownership of the subsidiary corporation constitutes stock in a passive holding company that is not considered a holding in a business enterprise.

LP's sole activity is the holding of the rights associated with X's episodes of Show and collecting royalties associated with the use therefrom generated under the agreements with Company. One hundred percent of the income from LP is derived from royalties, which are considered passive income under § 512(b)(2). Since over 95 percent of the partnership's income derives from passive sources, it is excluded from being a business enterprise under § 4943(d)(3)(B); thus Organization's ownership of partnership interests in LP does not constitute excess business holdings.

CONCLUSION

In light of the foregoing, we rule as follows:

1. Following the transfer of the license agreements, copyrights, publicity rights agreement and name/likeness rights to the LP, Y, sole owner of Company, will be able to serve as a director and officer of Organization without violating the provisions against direct or indirect self-dealing transactions with Organization within the meaning of IRC § 4941 and Treas. Reg. § 53.4941-1(b)(1);
2. Formation of LP and the proposed transfer of the copyrights, license agreements, publicity rights agreements and name/likeness rights to the LP will not constitute "excess business holdings" within the meaning of § 4943.

This ruling will be made available for public inspection under section 6110 of the Code after certain deletions of identifying information are made. For details, see enclosed Notice 437, Notice of Intention to Disclose. A copy of this ruling with deletions that we intend to make available for public inspection is attached to Notice 437. If you disagree with our proposed deletions, you should follow the instructions in Notice 437.

This ruling is directed only to the organization that requested it. Section 6110(k)(3) of the Code provides that it may not be used or cited by others as precedent.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

No ruling is granted as to whether Organization qualifies as an organization described in § 501(c), and except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

Sincerely,

Theodore Lieber
Senior Tax Law Specialist
(Tax Exempt & Government Entities)

cc: